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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 1146

THE COASTAL CLUB, INC., *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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No.

THE COASTAL CLUB, INC., *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above-entitled case on November 15, 1966, affirming a determination by the Tax Court of the United States that petitioner owed deficiencies in income taxes aggregating $244,513.81 for the fiscal years ended March 31, 1957 through 1960.

CITATIONS TO OPINIONS BELOW

The Tax Court decision below is reported at 43 T.C. 783 (1965), and is printed in Volume II of the Transcript of Record (R. 573-654). The Opinion below of the United

States Court of Appeals for the Fifth Circuit (R. 719-720), which is printed in Appendix A hereto, *infra*, p. 1a, is reported in 368 F. 2d 231 (1966).

JURISDICTION

The judgment below of the United States Court of Appeals for the Fifth Circuit, which is printed in Appendix A hereto, *infra*, p. 2a, was entered on November 15, 1966 and issued as a mandate on December 23, 1966. (R. 721) A petition for rehearing (R. 722-732), nine copies of which are submitted with this petition, was denied on December 15, 1966 (R. 733). The jurisdiction of this Court is invoked under 26 U.S.C. § 7482(a) and 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. The specific issue involved is whether respondent was justified in revoking (in 1961) petitioner's exemption as a social club under Section 501(c)(7) of the 1954 Code for the years in question (fiscal 1957-1960) on the ground that petitioner accepted too much outside income in the form of bonuses and royalties, not from the conduct of a business—but from unsolicited oil and gas agreements with three oil companies with respect to land which petitioner acquired in 1928 solely for club purposes, with no awareness at that time of any oil potential, and which petitioner has at all times since used for the club purposes of hunting and fishing.

2. An underlying question of significant importance is whether, if any such quantitative test of passive income which may be received by a social club is a desirable test of exemption, the guidelines for such a test should be fashioned (a) by the Congress (see *Commissioner of Internal Revenue* v. *Clay Brown, et al.*, 380 U.S. 563), or (b) by the courts on a case-by-case basis where the exemption statute is silent on the question but has been construed to permit receipt of substantial amounts of non-business income through the disposition of surplus property not use-

able *per se* for club purposes: *Anderson Country Club* v. *Commissioner*, 2 T.C. 1238, (acquiesced in by the Commissioner, 1944 C.B. 2); *Koon Kreek Klub* v. *Thomas*, 108 F. 2d 616; and *Scofield* v. *Corpus Christi Golf & Country Club*, 127 F. 2d 452. (See also pp. 10-11, *infra*, for implied construction by the Treasury Department.)

STATUTE INVOLVED

The pertinent provisions of Section 501 of the Internal Revenue Code of 1954 are as follows:

> "Sec. 501. EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC.
>
> (a) Exemption From Taxation—An organization described in subsection (c) or (d) or section 401 (a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502, 503 or 504.
>
> * * * * * * * * *
>
> (c) List of Exempt Organizations—The following organizations are referred to in subsection (a):
>
> * * * * * * * * *
>
> (7) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private shareholder."
>
> * * * * * * * * *
>
> (26 U.S.C. § 501.)

STATEMENT OF THE CASE

Petitioner was organized as a hunting and fishing club on June 27, 1928 (R. 528, 574, 575), and it thereupon acquired approximately 6,000 acres of land in southwestern Louisiana solely for duck hunting and fishing, (R. 576). No oil or gas was discovered in this area until long after petitioner acquired its acreage. (R. 700) On April 11, 1935, petitioner executed its first oil and gas lease covering

its entire 6,000 acres with one Walter C. Peters, who shortly thereafter assigned it to Shell Oil Company. (R. 578-579) Because of such lease, respondent ruled in June 1936 that petitioner had forfeited its exemption and was required to file Federal income tax returns for 1936 and subsequent years (although it was held to be exempt for years prior thereto). (R. 579)

Petitioner filed returns and paid the Federal taxes for several years and then filed claims for refund on the ground it was an exempt social club, but its claims were rejected by respondent. In 1940, petitioner requested that its claims for refund be reconsidered in view of the decision of the United States Court of Appeals for the Fifth Circuit in *Koon Kreek Klub* v. *Thomas*, 108 F. 2d 616, but respondent refused to change his position.[1] (R. 579) On February 4, 1941, petitioner filed suit for refund of these taxes against the United States in the U. S. District Court for the Western District of Louisiana (R. 580). By letter dated November 21, 1941, the United States Attorney suggested to petitioner's attorney that further action on the refund suit be withheld pending a decision by the United States Court of Appeals for the Fifth Circuit in the case of *Scofield* v. *Corpus Christi Golf & Country Club* which was then on appeal. Such letter stated that the *Corpus Christi* case involved "issues identical to those involved" in petitioner's case. (R. 580) On April 16, 1942, the United States Court of Appeals held in *Scofield* v. *Corpus*

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[1] The reason stated in respondent's letter dated April 11, 1940 was as follows (R. 487):

> "The development of this lease is in direct conflict to the purpose of a hunting and fishing club. The fact that the lease made provision for receipts greatly in excess of the needs of the club and which could destroy the usefulness of the preserve to the members for financial reward, is proof that this lease was not entered into for the purpose of operating a hunting and fishing club."

Christi Golf & Country Club, 127 F. 2d 452, that the social club involved therein was exempt from Federal income taxes, and shortly thereafter petitioner received a full administrative refund of the taxes involved in its refund suit. (R. 581)

By letter ruling dated July 17, 1943, respondent restored, retroactive to 1935, petitioner's exemption as a social club. (R. 479-481) Petitioner's application for such restoration reflected that it had already realized $48,010.59 in bonuses, rentals and royalties from the 1935 Shell lease which was still in effect with respect to a reduced amount of acreage (on which two producing wells had been drilled). (R. 584-585)

Since the July 17, 1943 exemption ruling, the only oil and gas leases into which petitioner has entered have been two leases with Shell Oil Company,[2] two leases with Pan American Oil Company and one lease with Sohio Oil Company, and no well was drilled on petitioner's acreage as the result of any of these agreements. In each instance, such agreement was solicited solely by the lessee, and no negotiations for any agreement were ever initiated by petitioner. (R. 602) Since August 1959, only 580 acres of petitioner's 6,000 acres, consisting of 360 acres from the 1935 Shell lease and 220 acres subject to a subsequent unitization agreement with Shell Oil Company and others, have remained subject to oil and gas agreements. Petitioner has never had any working interest in any oil or gas lease, nor has it ever participated in any oil or gas

[2] The first of which was in effect a partial settlement (in 1952) of drainage problems with respect to acreage still under the 1935 lease (R. 586) and the second of which was entered into in 1957 primarily for the purpose of extending Shell's rights under the 1952 lease which otherwise would have expired unless Shell had drilled a well, the cost of which (petitioner long afterward discovered) was estimated by Shell to be at least $834,000. (R. 590-592).

operations. (R. 666) Petitioner has never paid any cash dividends or made any other distributions to its shareholders. (R. 611) Petitioner has held its oil and gas income for use in meeting various expenditures to further its objectives as a hunting and fishing club. (R. 604, 608-609, 612-613)

By letter to petitioner dated June 20, 1961, respondent revoked his tax exemption ruling of July 17, 1943, retroactive to the fiscal year ended March 31, 1957 and subsequent years.[3] (R. 605) Such revocation letter presumably arose from the fact that petitioner received a bonus of $384,000 in March 1957 for entering into a new lease with Shell Oil Company with respect to 5,640 acres (R. 592-593), and received $62,040 from Pan American Petroleum Corporation in 1959 in consideration for the right to conduct a geophysical survey of such 5,640 acres. (R. 601)

By a notice of deficiency dated August 31, 1961, respondent asserted alleged Federal income taxes due from petitioner for the fiscal years ended March 31, 1957 through 1960 on the ground that petitioner did not qualify for exemption from tax. (R. 463-473)

On October 20, 1961, petitioner filed a petition in the Tax Court of the United States contesting the asserted deficiencies. (R. 450-518) In its Opinion filed on March 17, 1965, the Tax Court upheld the contention of respondent. (R. 573-654)

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[3] It is submitted that the reason given in such letter for the revocation of exemption, namely "that your mineral leases have resulted in your receipt of substantial, recurrent income from sources not related to the basis for exemption under section 501(c)(7)" (R. 517), was to all intents and purposes, the same as that used (and later conceded to be erroneous by the exemption ruling of July 17, 1943. R. 480) to deny petitioner exemption in 1940. (See footnote 1, *supra*, p. 4)

Petitioner filed a timely petition for review in the United States Court of Appeals for the Fifth Circuit on June 29, 1965, and on November 15, 1966 the Tax Court was affirmed by a *per curiam* Opinion (R. 719-720) which cited as authority therefor that Court's 2 to 1 decision in *United States* v. *Fort Worth Club of Fort Worth, Texas,* 348 F. 2d 891.[4]

REASONS FOR GRANTING THE WRIT

1. It is respectfully submitted that in the absence of any finding by the Tax Court below that petitioner's oil and gas lease transactions constituted engaging in business,[5] the conclusion of that Court that petitioner was not an exempt social club within the meaning of Section 501 (c)(7) during the taxable years at issue, as well as the apparent basis for such conclusion, both of which were adopted in the Opinion by the United States Court of Appeals for the Fifth Circuit, are in conflict with other authoritative interpretations of such exemption statute. The basis for the Tax Court's determination that petitioner had forfeited its exempt status as a social club

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[4] See footnote 6, *infra,* at p. 8.

[5] The conclusion is inescapable from the record below that the Tax Court recognized that petitioner had not engaged in business in the usual sense (R. 440), but, notwithstanding this, considered the possibility of finding, on the authority of *Mauldin* v. *Commissioner,* 195 F. 2d 714, affirming 16 TC 698 (opinion by trial judge in the instant case), that petitioner did engage in business by merely executing and receiving income from unsolicited oil and gas leases or agreements. (R. 440-441) The Tax Court, however, refrained from making any finding that petitioner was engaged in business, presumably because it would be contrary to the record below that petitioner had never had a working interest in any oil or gas lease nor participated in any oil or gas operations. (R. 626, 666, 685-686, and pages 3 and 4 of the petition for rehearing in the Court of Appeals below, R. 725-726).

appears to be, not that petitioner was engaged in business,[6] but rather that its leasing transactions "were entered into 'for the purpose of profit' and that the profits therefrom have been both regularly recurring and substantial". (R. 643) Such a criterion for revoking a social club's exemption, in the absence of a finding that the club engaged in an outside business, not only appears to have no case support, but is in conflict with:

(a) The Tax Court's conclusion in *Anderson Country Club, Inc.* v. *Commissioner*, 2 T.C. 1238 (1943), acquiesced in by respondent, 1944 C.B. 2, that the plotting and sale by a country club of 24 lots over a twelve-year period at a substantial profit did not cause a forfeiture of the club's exemption. After noting the Government's contention in that case "that by selling the real estate in question at a profit over a considerable period of time, petitioner had forfeited the right to claim the exemption", the Tax Court stated at pages 1242 and 1243:

> "The respondent's regulations recognize the fact that an incidental sale of property does not extinguish the right to an exemption. Considering 'incidental' in its ordinary sense to mean collateral or subordinate to the principal purpose, we think there is ample evi-

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[6] In the absence of a finding that petitioner in the instant case was engaged in its lease transactions as a business, the reliance of the United States Court of Appeals for the Fifth Circuit on its own decision in *United States* v. *Fort Worth Club of Fort Worth, Texas*, 348 F. 2d 891 (1965), in affirming the instant Tax Court decision below, appears misplaced, since the Court succinctly summarized in its holding in that case as follows at page 892:

> "In reversing the decision of the district court, we *held only* that the Fort Worth Club, because of substantial and recurring outside *business* income, is not entitled to exemption from income tax as a social club under section 501(c)(7) of the Internal Revenue Code of 1954." (Emphasis supplied.)

dence that the sales in question were incidental to the primary reason for the club's existence.

"The fact that the profits were in some years substantial does not affect the incidental nature of the sales. * * *"

(b) The Opinions of the United States Court of Appeals for the Fifth Circuit in *Koon Kreek Klub* v. *Thomas,* 108 F. 2d 616 (1939), and *Scofield* v. *Corpus Christi Golf & Country Club,* 127 F. 2d 452 (1942), the only two cases to date in which the question has arisen whether the receipt of oil and gas income by a social club from its own land deprives it of its exempt status. In each instance, the Court of Appeals sustained the exemption of the social club. In the *Koon Kreek* case, the Court of Appeals held that the club's leasing activities and the receipt of substantial funds therefrom, did not result in a forfeiture of the club's exemption because it did not engage in those activities as a business. In the *Corpus Christi* case [7] the Court of Appeals held that the club's receipt of substantial amounts of oil revenues by way of bonus, delay rentals and royalties (a situation admittedly "identical" with petitioner's situation under the 1935 lease) from a lease on its land did not cause the loss of its exemption because they were "merely an incident to the ownership of the land", and the club was neither "actively engaged in operating non-club activities", nor did it derive its income "from the public generally". (127 F. 2d at p. 454) In each of these two cases the crucial factor to the United States Court of Appeals for the Fifth Circuit was the fact that the club had, as in the instant case, a non-working interest in the oil and gas lease involved and consequently had nothing to do with the operations thereunder. In its recent opinion in *United States* v. *Fort Worth Club of Fort Worth, Texas,* 345 F. 2d 52, the United States Court of Appeals

[7] In that case, unlike the instant one, the club was aware of the oil potential when it acquired the land. (R. 576 and 700)

for the Fifth Circuit emphasized the non-business nature of the oil and gas revenue received by the clubs in the *Koon Kreek* and *Corpus Christi* cases as the correct ground for the decisions reached therein, and it was on this basis that the Court of Appeals distinguished these cases from the commercial lease operations of the Fort Worth Club then before it.[8]

(c) The clear implication in respondent's sponsorship, through the Assistant Secretary of the Treasury, of companion bills, H.R. 15942 and H.R. 15943[9], in the Second Session of the 89th Congress (Appendix B, *infra*, pp. 1a to 9a), that there is no ban under present law on the receipt by a social club, or any other tax exempt organization, of outside *non-business income* and no legislative policy for invoking such a ban so long as the income is produced solely through the investment of a social club's own funds. This is made clear in Assistant Secretary Surrey's statement in support of the bills (Appendix B, *infra*, pp. 9a to 19a). He pointed out that all exempt organizations (including social clubs) would simply be taxed

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[8] Petitioner also brought to the attention of the Court of Appeals below the apparent conflict in respondent's own position as evidenced by statements in his brief on appeal in the *Fort Worth Club* case. He distinguished the *Koon Kreek and Corpus Christi* cases on the basis that all that was involved in those cases was the disposition "of surplus property (mineral rights) which was of no use to the club", and stated that the receipts therefrom fell in one of the several categories of club income held to be "merely incidental to the activities of a social club and not to destroy its exemption" namely, the category of "income from the sale of windfall property, such as mineral rights, which is discovered upon club property". See pp. 5 and 6 of the petition for rehearing in the instant case. (R. 727-728)

[9] Mr. Surrey testified as to such bills in Hearings before the Ways and Means Committee on August 29, 1966, pp. 19-25, and pointed out that the bills were the product of a joint study by the staff of the Joint Committee on Internal Revenue Taxation and the Treasury technical staff. (Appendix B, *infra*, p. 10a)

on their income from debt-financed investments (Appendix B, *infra*, pp. 16a to 17a):

> "* * * Under the bills, income would be subject to tax *only* if it meets two tests: it would have to be derived from property acquired or improved with borrowed funds, and its production would have to be 'unrelated' to the educational, charitable, religious, or other operations constituting the basis of the organization's tax exemption.
>
> "*Income produced by investments of an organization's own funds would be unaffected by the bills.* * * *" (Emphasis supplied)

Thus the Assistant Secretary's statement clearly implies that under present law a social club may, without losing its exemption, receive outside *non-business income* without limit [10] as to amount from its own property, and under the proposed bills this would be changed only as to debt-financed income.

In summary, the *Anderson Country Club, Koon Kreek* and *Corpus Christi* cases, and Assistant Secretary Surrey's representations to the Congress all clearly recognize that the passive receipt of even substantial amounts of non-business income does not deprive a social club of its exemption. The only possible basis for distinguishing the instant case, therefore, must be, as one of the Judges suggested to respondent's counsel at the hearing on the appeal below (R. 729), that the amount of such income which petitioner received was too much. It is respectfully submitted that the courts should not superimpose such a cut-off rule on the existing requirements for exemption under Section 501(c)(7) where the statute itself is silent in that regard.

The Congress reviewed and passed legislation with respect to the taxation of exempt organizations in 1950 (Ap-

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[10] This is consistent with respondent's statements in his brief on appeal in the *Fort Worth Club* case. See footnote 8, page 10, *supra*.

pendix B, *infra*, pp. 14a-15a), and in 1966 the above-mentioned two bills were introduced in Congress (one by the Chairman of the Ways and Means Committee) to amend such legislation based on joint studies by Congressional and Treasury staffs. Under such circumstances, if there should be a cut-off point on the amount of passive income which may be received by an exempt social club, it is respectfully submitted that the rule should be fashioned by the Congress and not the courts. The following observation of this Court in the case of *Commissioner of Internal Revenue* v. *Clay Brown, et al.*, 380 U.S. 563, 579 (1965) would seem to apply with equal force in this case:

> "The problems involved in the purchase of a going business by a tax-exempt organization have been considered and dealt with by the Congress. Likewise, it has given its attention to various kinds of transactions involving the payment of the agreed purchase price for property from the future earnings of the property itself. In both situations it has responded, if at all, with precise provisions of narrow application. *We consequently deem it wise to 'leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications.' American Automobile Assn.* v. *United States*, 367 U.S. 687, 697." (Emphasis supplied)

2. Clearly the questions presented by this petition for certiorari are of substantial importance in the administration of Section 501(c)(7) of the 1954 Code, for to the best of petitioner's knowledge, the Tax Court decision below, which was adopted by the United States Court of Appeals for the Fifth Circuit, is the first case in which a court has held that a social club not engaged in business loses its exemption merely because it realizes too much income from the disposition of its surplus property, consisting of mineral rights which were acquired merely as an incident to the ownership of land and which were of no use to the club.

The urgent need for the United States Supreme Court to resolve the above-noted conflicts between the decisions of the Tax Court and the United States Court of Appeals

for the Fifth Circuit below, on the one hand, and the above-noted other authoritative interpretations of Section 501 (c)(7), on the other hand, is highlighted by the extreme position recently taken by respondent as to the receipt of passive non-business income of a social club in Revenue Ruling 66-149, I.R.B. 1966-22, 17. Such Ruling states (p. 18) that "a social club is not exempt from Federal income tax as an organization described in section 501(c)(7) of the Code where it regularly derives a substantial part [11] of its income from nonmember sources such as, for example, dividends and interest on investments which it owns". While petitioner does not believe that such quoted statement correctly reflects present law, particularly in the light of Mr. Surrey's above-quoted testimony, yet such Revenue Ruling increases the need for the Supreme Court to determine the nature of the outside non-business income which a social club may realize without forfeiting its statutory exemption and decide whether existing law imposes any quantitative limitation on such income. Undoubtedly, many social clubs have relied upon the correctness of the above-noted prior court decisions in utilizing outside income of a purely passive nature to carry out their exempt purposes.

The problem is particularly acute for those social clubs, which, like the instant petitioner, find that they have potential "windfalls" [12] in the form of subsequently-discovered natural resources or appreciation in property acquired in good faith solely for club purposes which, *per se*, cannot be used for such purposes. Must they refrain from converting such increments and using the proceeds for club purposes? Must they, in any event, limit such conversion and use to a relatively small amount or percentage each year? If the decisions below in the instant case and

[11] In Revenue Procedure 64-36, 1964-2 C.B. 962, 963, respondent sets forth as an audit technique for determining when such outside income becomes substantial the cut-off point of $2,500 annual gross receipts or 5% of total annual gross receipts.

[12] See footnote 8, p. 10, *supra*.

Revenue Ruling 66-149 referred to above are valid, social clubs which find themselves so situated must do just that or risk losing their exemption because either a realization or a distribution of such increments can cause a forfeiture of exemption. It is respectfully submitted that, in the absence of statutory language in Section 501(c)(7) which clearly imposes such a harsh dilemma, the Courts should not infer any Congressional intent to do so. In any event, there is obviously an urgent need for a clarifying decision by the Supreme Court in this area.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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Certificate of Service

It is hereby certified that on this day personal service of a copy of this Petition for Certiorari has been made on the Solicitor General of the United States and on Honorable Mitchell Rogovin, Assistant Attorney General of the United States, in compliance with Paragraph 2 of Rule 33 of the Rules of the Supreme Court of the United States.

Dated: 14th day of March, 1967.

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Counsel for Petitioner

APPENDIX A

APPENDIX A

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 23005

THE COASTAL CLUB, INC., *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

On Petition for Review of Decision of the Tax Court of the United States (Louisiana Case).

(November 15, 1966.)

Before JONES, WISDOM and GOLDBERG, Circuit Judges.

PER CURIAM: Before us for review is a decision of the Tax Court of the United States revoking the tax exemption of the petitioner, The Coastal Club, Inc., and holding it liable for income tax upon monies received from oil and gas leases. *The Coastal Club, Inc.* v. *Commissioner of Internal Revenue*, 43 T.C. 783. This Court, finding itself in complete agreement with the conclusion which the Tax Court reached and with its opinion, affirms its decision. See *United States* v. *Fort Worth Club*, 348 F. 2d 891.

AFFIRMED.

Before JONES, WISDOM and GOLDBERG, Circuit Judges.

Judgment

This cause came on to be heard on the petition of The Coastal Club, Inc., for review of a decision of the Tax Court of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered, adjudged and decreed by this Court that the decision of the Tax Court in this cause be, and the same is hereby, affirmed.

November 15, 1966

Issued as Mandate: Dec. 23, 1966

APPENDIX B

APPENDIX

89TH CONGRESS—2D SESSION

H. R. 15942

IN THE HOUSE OF REPRESENTATIVES

June 27, 1966

Mr. MILLS introduced the following bill; which was referred to the Committee on Ways and Means

A BILL

To impose a tax on unrelated debt-financed income of tax exempt organizations.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 511 (a) (2) (A) of the Internal Revenue Code of 1954 (relating to organizations subject to the tax on unrelated business income) is amended to read as follows:

"(A) ORGANIZATIONS DESCRIBED IN SECTIONS 401 (a) AND 501 (c).—The taxes imposed by paragraph (1) shall apply in the case of any organization (other than a trust described in subsection (b)) which is exempt, except as provided in this part, from taxation under this subtitle by reason of section 401 (a) or section 501 (c)."

SEC. 2. Section 512 of such Code (relating to definition of unrelated business taxable income) is amended—

(a) by redesignating subsections (b) and (c) as subsections (d) and (e) respectively;

(b) by striking out paragraph (4) (relating to business leases) of the new subsection (d);

(c) by striking out in the new subsection (e) (relating to special rules applicable to partnerships) the phrase "subsection (b)" and inserting in lieu thereof "subsection (d)"; and

(d) by striking out so much of such section 512 as precedes paragraph (1) of the former subsection (b) (redesignated above as subsection (d)) and inserting in lieu thereof the following:

"SEC. 512. UNRELATED BUSINESS TAXABLE INCOME.

"(a) ORGANIZATIONS TAXED ON TWO CATEGORIES OF UNRELATED INCOME.—In the case of any organization (other than a church or a convention or association of churches) which is exempt, except as provided in this part, from taxation under this subtitle by reason of section 401 (a) or of paragraph (3), (5), (6), (14) (B) or (C), or (17) of section 501 (c), and in the case of any trust described in section 511 (b), and in the case of any college or university described in section 511 (a) (2) (B), the term 'unrelated business taxable income' means the sum of:

"(1) the gross income derived by it from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the exceptions, additions, and limitations provided in subsection (d), and

"(2) the amount of its unrelated debt-financed income (as computed under section 514).

Such definition of unrelated business taxable income shall also apply in the case of a corporation described in section 501 (c) (2) (relating to a corporation organized to hold title to property) if its income is payable to an organization described in the preceding sentence or to a church or to a convention or association of churches.

"(b) ORGANIZATIONS TAXED ONLY ON UNRELATED DEBT-FINANCED INCOME.—In the case of any organization exempt from taxation by reason of section 501 (c) and to which the definition in subsection (a) is not applicable, the

term 'unrelated business taxable income' means the amount of its unrelated debt-financed income (as computed under section 514).

"(c) FOREIGN ORGANIZATIONS.—In the case of an organization described in section 511 which is a foreign organization, the unrelated business taxable income (under subsection (a) or (b), whichever is applicable) shall be its unrelated business taxable income derived from sources within the United States determined under subchapter N (section 861 and following, relating to tax based on income from sources within or without the United States).

"(d) EXCEPTIONS, ADDITIONS, AND LIMITATIONS.—The following exceptions, additions, and limitations are applicable in determining under subsection (a) (1) the gross income and deductions attributable to an unrelated trade or business:".

SEC. 3. Section 514 of such Code (relating to business leases) is amended—

(a) by redesignating subsections (b), (c), and (d) as subsections (g), (h), and (i) respectively;

(b) by striking out, in paragraph (1) of the new subsection (g), the phrase "subsection (c)" and inserting in lieu thereof "subsection (h)";

(c) by striking out, in paragraph (1) of the new subsection (h), the words "the unpaid amount of—" and inserting in lieu thereof "the unpaid amount of the indebtedness incurred by the lessor before June 28, 1966, which is—"; and

(d) by striking out so much of such section 514 as precedes the former subsection (b) (redesignated above as subsection (g)) and inserting in lieu thereof the following:

"SEC. 514. UNRELATED DEBT-FINANCED INCOME.

"(a) DEFINITION.—For purposes of section 512 the term 'unrelated debt-financed income' means the aggregate of the amounts of gross income taken into account during the taxable year under subsection (b) with respect to debt-financed property owned by the organization, less the aggregate of the amounts of the deductions taken into account under subsection (c) on account of such property.

"(b) PERCENTAGE OF INCOME TAKEN INTO ACCOUNT.—In computing unrelated debt-financed income there shall be included and taken into account with respect to each debt-financed property owned by the organization during the taxable year an amount which is the same percentage (but not in excess of 100 percent) of the total gross income derived during the taxable year from or on account of such property as (1) the average acquisition indebtedness for the taxable year with respect to the property is of (2) the adjusted basis of such property at the close of the taxable year. If the property is disposed of during the taxable year, then the adjusted basis shall be so determined as of the time of disposition. If the property was acquired in a distribution by a corporation with respect to its stock, the basis of the property, for the purposes of this subsection and paragraph (2) of subsection (c), shall be the same as it would be in the hands of the transferor corporation, increased by the amount of grain recognized to the transferor corporation upon such distribution and by the amount of any gain to the organization which was included, on account of such distribution, in its unrelated debt-financed income.

"(c) PERCENTAGE OF DEDUCTIONS TAKEN INTO ACCOUNT.—There shall be allowed with respect to each debt-financed property, as a deduction to be taken into account in computing unrelated debt-financed income, an amount determined by applying the percentage derived under subsection (b) to the sum of the deductions allowed by this chapter

which are directly connected with the debt-financed property or the income therefrom, except that such deductions shall be computed with the following exceptions, additions, and limitations:

"(1) No deduction shall be allowed under sections 243, 244, and 245 (relating to dividends received by corporations).

"(2) If the debt-financed property is of a character which is subject to the allowance for depreciation provided in section 167, the allowance for exhaustion, wear and tear shall be computed only by use of the straight line method.

"(3) The net operating loss deduction provided in section 172 shall be computed in the manner provided in paragraph (6) of section 512 (d), and the deduction allowed by section 170 (relating to charitable, etc., contributions and gifts) shall be computed in accordance with the provisions of paragraph (10) or (11) of section 512 (d), whichever is applicable, but a double deduction in computing unrelated business taxable income shall in no case be allowed.

"(4) There shall be allowed a specific deduction of $1,000 less the amount deducted by the organization under paragraph (12) of section 512 (d).

"(d) DEFINITION OF DEBT-FINANCED PROPERTY.—The term 'debt-financed property' means any property which is held to produce income and with respect to which there is an acquisition indebtedness (as defined in subsection (e)) at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition), except that such term does not include—

"(1) any property all the use of which is related (aside from the need of the organization for income

or funds) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511 (a) (2) (B), to the exercise or performance of any purpose or function designated in section 501 (c) (3));

"(2) any property all the income from which is taken into account in computing the gross income of any unrelated trade or business, if section 512 (a) is applicable for the taxable year to the organization;

"(3) any property all the income from which is excluded by reason of the provisions of paragraph (7), (8), or (9) of section 512 (d) in computing the gross income of any unrelated trade or business (or would be excluded by such provisions if section 512 (a) were applicable to the organization); or

"(4) any property all the use of which is in any trade or business described in paragraph (1), (2), or (3) of section 513 (a).

"(e) ACQUISITION INDEBTEDNESS.—

"(1) GENERAL RULE.—The term 'acquisition indebtedness' means, with respect to any debt-financed property, the unpaid amount of—

"(A) the indebtedness incurred by the organization in acquiring or improving such property;

"(B) the indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition and improvement; and

"(C) the indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for

such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement, except that in the case of any taxable year beginning before January 1, 1972, any indebtedness incurred prior to June 28, 1966, shall not be taken into account unless the following sentence is applicable. In the case of a taxable year beginning before January 1, 1972, of an organization to which subsection (a) of section 512 is applicable, the term 'acquisition indebtedness' also includes, with respect to real property subject to a business lease (as defined in subsection (g)), any indebtedness incurred before June 28, 1966, if such indebtedness constitutes business lease indebtedness (as defined in subsection (h)).

"(2) PROPERTY ACQUIRED SUBJECT TO MORTGAGE, ETC.—Where property (no matter how acquired) is acquired subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage or lien shall be considered as an indebtedness of the organization incurred in acquiring such property even though the organization did not assume or agree to pay such indebtedness.

"(3) EXTENSION OF OBLIGATIONS.—An extension, renewal, or refinancing of an obligation evidencing a preexisting indebtedness shall not be treated, for the purposes of this section, as the creation of a new indebtedness.

"(4) AVERAGE ACQUISITION INDEBTEDNESS.—The term 'average acquisition indebtedness' for any taxable year with respect to a debt-financed property means the average amount, determined under regulations prescribed by the Secretary or his delegate, of the acquisition indebtedness during the period the property is held by the organization during the taxable year, except that for the purpose of computing the

percentage of any gain or loss to be taken into account on a sale or other disposition of debt-financed property, such term means the highest amount of the acquisition indebtedness with respect to such property during the 12-month period ending with the date of the sale or other disposition.

"(f) ALLOCATION RULES.—

"(1) RELATED INCOME FROM PORTION OF PROPERTY.—Where a portion of debt-financed property is held solely for uses, or solely to produce income, described in paragraph (1), (2), (3), or (4) of subsection (d), proper allocation of the adjusted basis of the entire property and of the indebtedness with respect to the entire property shall be made to such portion. The amounts so allocated shall be excluded, for the purposes of this section, in computing the adjusted basis and the acquisition indebtedness of the debt-financed property.

"(2) MULTIPLE USE OF SAME PROPERTY.—If debt-financed property is partially devoted to a use described in paragraph (1) or (4) of subsection (d), or produces some income described in paragraph (2) or (3) of subsection (d), the income and deductions attributable to such use, and the income described in such paragraph (2) or (3) and deductions properly allocable thereto, shall be excluded under subsections (b) and (c) in computing the unrelated debt-financed income from such property.

"(3) REGULATIONS.—The allocations and exclusions provided for in paragraphs (1) and (2) shall be made in accordance with regulations prescribed by the Secretary or his delegate."

SEC. 4. Section 681 (a) of such Code (relating to limitation on charitable deduction of taxable trusts) is amended by striking out the words "certain leases" and inserting

in lieu thereof "certain property acquired with borrowed funds".

SEC. 5. The amendments made by this Act shall apply to taxable years ending after the date of the enactment of this Act, except that—

(a) income received or accrued on or before such date of enactment and related deductions shall be taken into account in computing unrelated business taxable income only to the extent they would have been taken into account without regard to the amendments made by this Act; and

(b) in the case of a taxable year beginning before but ending after the date of the enactment of this Act, income and deductions with respect to a business lease (as defined in section 514 of such Code) shall be taken into account in computing unrelated business taxable income without regard to the amendments made by this Act.

Statement of Hon. Stanley S. Surrey, Assistant Secretary of the Treasury; Accompanied by Jerome Kurtz, Tax Legislative Counsel; and Thomas A. Troyer, Attorney, Office of Tax Legislative Counsel

Mr. SURREY. Thank you, Mr. Chairman.

I have with me Mr. Kurtz and Mr. Troyer of my office. I appreciate the opportunity to appear before your committee to explain the views of the Treasury Department on H.R. 15942 and H.R. 15943. These two bills, which are identical, relate to a group of problems which have been of serious concern to Congress before—the problems generated when tax-exempt organizations borrow money for purposes unrelated to their exempt functions.

Those problems were considerably intensified last year by the decision of the Supreme Court in *Commissioner v. Clay B. Brown.*

For several reasons, the Treasury Department strongly supports these bills, which Chairman Mills and Mr. Byrnes have introduced.

I might say that these bills came about as a result of a study conducted jointly by the staff of the joint committee and the Treasury technical staff and this study was one requested by the chairman and Mr. Byrnes last year.

To make clear the grounds for our support, let me first describe the *Brown* case briefly and outline the exempt organization problems which it highlights. With that background, I can then explain how the proposed bills work and why it is our view that, in their continuation of an approach adopted by Congress in 1950 to deal with one form of exempt organization, investment borrowing, they would resolve these problems effectively and fairly, and without impeding the legitimate functions of the organizations to which Congress has accorded the privilege of tax exemption.

To go to the *Brown* case, that involved a situation in which an exempt organization acquired a sawmill and lumber business by agreeing to pay the former owners a percentage of the future profits of the business until a specified maximum amount had been reached.

Making no commitment for payment other than from the assets of the transferred business itself and the income produced by those assets, the exempt organization obtained the business—valued at $1,300,000—without any investment of its own funds.

Careful steps were taken to immunize the earnings of the enterprise from the present tax on unrelated business income. The question before the Supreme Court was the tax treatment of the former owners of the business; the exemption of the organization was not in issue. With three Justices dissenting, the Court held that the former owners were entitled to treat their profits on the transaction as capital gains.

Alarmed by the implications of the decision, the dissenting opinion pointed out that—

> In any realistic sense the Government's grant of a tax exemption was used by the (exempt purchaser) as part of an arrangement that allowed it to buy a business that in fact cost it nothing. I cannot believe that Congress intended such a result. * * * Unless Congress repairs the damage done by the Court's holding, I should think that charities will soon own a considerable number of closed corporations, the owners of which will see no good reason to continue paying taxes at ordinary income rates. * * * The tax avoidance routes opened by the Court's opinion will surely be used to advantage by the owners of closed corporations and other income-producing assets in order to evade ordinary income taxes and pay at capital gain rates, with a resultant large-scale ownership of private businesses by tax-exempt organizations.

The majority and concurring Justices also referred to the area as one for congressional action.

Turning to the unfortunate consequences of exempt organization investment borrowing, the availability of the tax exemption for use in transactions following the *Brown* pattern, and in other arrangements involving borrowing for investment purposes, has three very unfortunate consequences.

Incentive for shift of productive property to exempt sector: First, in any acquisition in which the purchase price is to be financed from the future earnings of the transferred property, tax-exempt organizations are peculiarly suited to pay a substantially higher price—and pay it more rapidly—than a taxable purchaser could afford.

They can, in effect, make available to the seller the additional business earnings which would have been paid

to the Government as taxes had the purchaser been taxable. The particular advantage of exempt organizations as purchasers in transactions of this sort has for some time been widely advertised in the tax and business press, and since the *Brown* decison such advertising has intensified.

Several examples are attached to this statement. I draw your attention particularly to a page of the Prentice-Hall Executives' Tax Report entitled "Boosting Profits."

Asking "Have You Put a Price on Your Business?" the announcement provides an arresting and enticing answer: "You May Be Able To Double It — By Selling to a Charity."

With the due attractions to sellers of higher prices and Supreme Court approved capital gains treatment, it seems quite likely that, unless something is done, a substantial unplanned shift of productive property to the exempt sector of our economy will occur.

One result of such a shift would, clearly, be very considerable erosion of the income tax base. Another might well be broad economic and social changes stemming from the ownership of a large number of businesses by organizations with different motives and different objectives than the entrepreneurs who have thus far constituted our business community.

Diversion of exemption benefit to private parties: A second undesirable result typically attends borrowing by exempt organizations for investment purposes. The price inflation characteristic of Brown-type transactions and common in other exempt organization borrowing situations deflects, to the personal benefit of private parties, a substantial portion of the advantage which Congress intended tax exemption to produce for the organizations upon which it conferred that exemption.

When sellers obtain the increase in purchase price made possible by the tax exemption of future earnings, they

draw a significant share of the advantage of the exemption to themselves. In effect, the purchasing organization trades temporary use of its exemption for the opportunity to own the property completely in the future.

This result has commonly been described as the organization's "selling its exemption."

Exempt organization expansion from within: A third unfortunate consequence follows from exempt organization investment borrowing. This investment borrowing enables an exempt organization to convert its tax exemption into a self-sufficient device for the production of capital.

By borrowing, the organization can extend the function of its exemption beyond the protection of income stemming from charitable contributions or membership fees; it can use the exemption to develop funds even where there are no contributions or membership fees.

Commentators have referred to this activity as "trading upon" or "capitalizing" the tax exemption. The organization which makes such use of its exemption can sever itself from reliance upon contributors or members and eliminate the healthful scrutiny of its purposes and activities which that reliance implies.

By this extension of its exemption privilege to borrowed assets and this separation from dependence upon contributors or members, the organization begins a multiplication of its holdings which bears no relation to the community's evaluation of its exempt activities; it embarks upon an extension of its economic holdings which is limited only by the financial acumen and commercial skills of its managers.

An organization involved several years ago in Tax Court litigation, for example, began with a net worth of $1,000 and—by means of borrowing—within 5 years had increased its holdings to include a 34-acre tract of industrial real property worth $1,150,000.

Another organization, formed in 1954 with no funds of its own at all, entered upon a program of investing in oil payments with borrowed money. By 1961 the organization had incurred indebtedness of more than $14 million, and had net income of almost $70,000 a year.

Remarkable as they are, these situations are by no means atypical illustrations of the consequences of unrestricted exempt organization borrowing for investment purposes.

Previous congressional action: In 1950 Congress recognized the impropriety and danger inherent in such exploitation of the tax-exemption privilege. Concerned with a proliferation of situations in which exempt organizations were purchasing commercial property, leasing it back to the original owners, and utilizing future rents from the property to pay the purchase loan, both this committee and the Senate Finance Committee stated that, and this is a quotation from the committee report:

> (One) objection to the lease-back is that it is altogether conceivable that if its use is not checked, exempt organizations in the not-too-distant future may own the great bulk of the commercial and industrial real estate in the country. This, of course, would lower drastically the rental income included in the corporate and individual income tax bases. The fact that under present law an exempt institution need not use any of its own funds in acquiring property through lease-backs—borrowed funds may represent 100 percent of the purchase price—indicates that there is no limit to the property an exempt institution may acquire in this manner. Such acquisitions are not in any way limited by the funds available for investment on the part of the exempt institution. This explains why particular attention should be given to lease-backs which involve the use of borrowed funds. Where an exempt organization uses its own funds, expansion of its property holdings through the lease-back device must

necessarily proceed at a much slower pace. (H. Rep. No. 2319, 81st Cong., 2d Sess. 39 (1950), 1950-2 Cum. Bull. 410; S. Rep. No. 2375, 81st Cong., 2d Sess. 31 (1950), 1950-2 Cum. Bull. 506.)

To deal with the problem, the Revenue Act of 1950 provided, generally, for taxation of a portion of the rent which certain types of exempt organizations receive from property acquired with borrowed funds.

The fundamental approach of this provision (which has continued without material change as sec. 514 of the present Internal Revenue Code) was a simple and sound one: Tax exemption should be restricted to earnings arising from the exempt entity's own assets, so as to eliminate the abuses and artificial incentives attendant upon exemption of income produced by borrowed funds.

Despite the essential soundness of its policy, the form which the 1950 act took has proved to contain several defects. Because the provision was engrafted upon legislation which had the rather different objective of taxing the business activities of exempt organizations—whether the organization owned them outright or not—it was made applicable only to those classes of organizations which Congress thought to be then significantly involved in business. As a result, it imposes no restraint whatever upon the abuses which arise when other kinds of exempt organizations borrow to invest.

Again, because the measure was drafted to cope with the particular variety of investment borrowing specifically drawn to the attention of Congress in 1950—the leaseback—it was made applicable only to rental income. It thus affords no solution to the same fundamental problems which exist where the income produced by borrowed funds is realized in the form of royalties, dividends, interest, or capital gains.

Finally, even in the area to which it does apply—even, that is, where the exempt organization is in one of the classes covered by the legislation and where its investment is in rental property—the 1950 act has been crippled by the presence of an exception which permits rents from leases whose terms are not longer than 5 years to be received without tax.

Tax planners have taken full and repeated advantage of these deficiencies of the 1950 legislation. The situation involved in the *Brown* case typifies a growing body of transactions in which exempt organization have fashioned their acquistions of productive property to avoid the impact of the provision.

Indeed, even before the announcement of the Supreme Court decision in *Brown,* more than 30 similar cases—in which, for one reason or another, the tax imposed under the 1950 act was, or was claimed to be, inapplicable—were pending before the courts or the Internal Revenue Service.

With the impetus added by Supreme Court approval of capital gains treatment for the sellers, the already well-traveled avenues around the 1950 act can be expected to become thoroughfares.

Turning to the proposed bills, which, as I say, are the product of a joint study by the staff of the joint committee and the Treasury staff, the proposed bills continue the basic approach of the 1950 provision, but eliminate the deficiencies which experience has demonstrated that provision to possess.

The bills impose income tax upon the "unrelated debt financed income" of all exempt organizations described in sections 401(a) and 501(c) of the Internal Revenue Code. Under the bills, income would be subject to tax only if it meets two tests: it would have to be derived from property acquired or improved with borrowed funds, and its production would have to be "unrelated" to the educational,

charitable, religious, or other operations constituting the basis of the organization's tax exemption.

Income produced by investments of an organization's own funds would be unaffected by the bills. Further, borrowing by an exempt organization for its exempt purposes—for example, borrowing by a college to build a dormitory—would fall beyond the scope of the proposals.

The taxable portion of the unrelated income from any particular property would, in general, be the amount bearing the same ratio to the total income from the property as the amount of the average indebtedness for the year bears to the basis of the property at the end of the year.

Deductions would be limited by the same percentage figure. Certain special rules would be employed to prevent avoidance of the tax by shifting deductions from years in which indebtdness is largely or completely discharged to earlier years in which it is high. Depreciation, for example, would be limited to the straight-line method.

Generally, during the next 5 years the new rules would apply only where indebtedness has been incurred after the date of the bills' introduction (June 27, 1966) and only to income received after the date of enactment.

The 5-year transition period would afford organizations with previously initiated unrelated borrowing an opportunity to prevent or minimize tax under the new rules by disposing of their acquisitions for fair value, by discharging indebtedness in full with exempt income or other assets, or at least by reducing the amount of outstanding indebtedness.

After the transition period, the new rules would become applicable to all situations of exempt organization investment borrowing.

There is a more detailed explanation of the mechanics of the bill attached.

To eliminate any possible misunderstanding, I should like to make very plain what the proposed bills do not do.

First, they do not have any effect upo nthe exempt organization which invests only its own funds. They apply only to the organization which borrows—the organization which is earning money with someone else's funds.

Second, they have no effect upon the organization which borrows in pursuance of its exempt activities. Only the production of income unrelated to those activities results in tax.

Third, the bills do not change the rules which Congress enacted in 1950 for the taxation of businesses owned outright by exempt organizations. Those rules, with their present exceptions and exclusions, would remain as they are.

Finally, the bills do not single out any one kind of exempt organization and impose a special tax upon it. They apply equally to all categories of organizations exempted under the general exemption section of the Internal Revenue Code.

In passing, I should like to point out also that the bills do not deal with the Supreme Court's grant of capital gains treatment to the sellers in transactions of the *Brown* type.

While extension of capital gains privileges to transfers of the *Brown* pattern may lead to abuses beyond the exempt organization field, the *Brown* transfer has sufficient elements in common with some kinds of ordinary commercial transactions to make it important that care be taken in any legislative withdrawal of capital gains treatment.

Further, the overwhelming majority of transfers in the *Brown* mold have thus far been to exempt organizations, and it may well be that, as a practical matter, adoption of the present bills would obviate the necessity of dealing with the capital gains issue.

In view of those facts, and in view of the urgency of attention to the exempt organization problems arising under

the *Brown* decision, we have concluded that it would be best to now deal with the primary problem area—the abuses and pressures produced by exempt organization investment borrowing—and to subject the future experience of the Internal Revenue Service and the development of the case law to continuing careful scrutiny to determine whether the capital gains problems possess sufficient practical importance to warrant legislative action.

In closing, let me emphasize that the present fortuitous, but very powerful, incentive for the transfer of businesses and other classes of productive property to exempt organizations requires effective and prompt congressional action.

As I have mentioned, even before the *Brown* decision gave Supreme Court sanction to the capital gains treatment claimed by the sellers in such arrangements, a considerable number of these transfers had occurred.

If Congress does not deal with the problem—and deal with it quickly—a great many more will take place. We have, for example, been informed that even in the brief span since the Supreme Court decision one organization has managed to acquire seven separate businesses.

Advertisements by exempt organizations in the Wall Street Journal (copies of several of which are appended to this statement) afford another indication of what will come.

The proposed bills employ an approach which Congress has already approved in dealing with problems of this character. It is an approach which would have no effect at all upon exempt organizations limiting themselves to use of their own funds—or even of borrowed funds related to their exempt activities—and which does no more than place those organizations borrowing for unrelated investment purposes upon the same tax ground as other taxpayers.

Because the need for legislation here is great and the proposed bills are effective, fair, and moderate, the Treasury Department strongly recommends that the Ways and Means Committee approve them.

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 1146

THE COASTAL CLUB, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner is a corporation organized in 1928 primarily as a duck hunting club under the non-trading corporation laws of the State of Louisiana. Upon its organization, petitioner acquired approximately 6,000 acres of marshland with a clubhouse thereon. Petitioner has realized substantial and recurring income from oil and gas leases which it has executed on this land. The question presented is whether because of this substantial income and the surrounding activities petitioner has lost its exemption from income tax under § 501(c)(7) of the 1954 Code which exempts the income of:

> Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable

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> purposes, no part of the net earnings of which inures to the benefit of any private shareholder.

The Tax Court upheld the Commissioner's determination that petitioner was not exempt for the taxable years in issue (1957–1960). The court of appeals affirmed *per curiam*. (R. 574, 576, 654; Pet. App. A 1a–2a.)

The decision below is correct and there is no conflict of decisions or other basis for further review by this Court.

1. Petitioner fails to qualify under § 501(c)(7) because it had a profit-seeking operational purpose and because some of those profits clearly inured to the benefit of its member-shareholders.

In its *per curiam* affirmance of the decision of the Tax Court, the court of appeals cited and followed its own earlier opinion in *United States* v. *Fort Worth Club of Fort Worth, Texas*, 345 F. 2d 52 (C.A. 5), modified and reaffirmed, 348 F. 2d 891. In *Fort Worth Club*, the court emphasized that the legislative history of § 501(c)(7)'s social club exemption indicates that the outside profits of such a club are not immune from taxation merely because they are used for club purposes. Such club-related use does not make social clubs exempt from taxation, since Congress did not grant them exemption because it desired to foster their activities. Rather, it was felt that the taxes collected would be negligible. See also H. Rep. No. 922, 64th Cong., 1st Sess., p. 4 (1939–1 Cum. Bull. (Part 2) 22, 24). Accordingly, the court held that, in order for a social club to qualify for tax-exempt status, its outside profits must be strictly inci-

dental to club activities and either negligible or non-recurring. In that case and in the case at bar, the profit-seeking activities of the taxpayer-club were unrelated to its exempt purposes and the profits therefrom were so substantial and recurring that the club was not "supported solely by membership fees, dues and assessments" as required by Treasury Regulation § 1.501(c)(7)–1, the regulation which was upheld by the Fifth Circuit in *Fort Worth Club*.

During the years in issue (1957–1960), petitioner received over $489,000 in outside profits from oil and gas leases, while its income from club-related sources was $35,000. Petitioner has received income from oil and gas leases in every year from 1944 through 1963, the average annual amount of which exceeds $44,000 (R. 607).

In addition, it cannot be doubted that the oil and gas profits "inured" to the benefit of petitioner's member-shareholders. Petitioner's expenditures for club purposes were as much as five times the amount collected in dues and charges from its members during the years at issue. It is well settled that the earnings of a club may inure to the benefit of its member-shareholders although the earnings themselves are not distributed. See *West Side Tennis Club* v. *Commissioner*, 111 F. 2d 6, 8 (C.A. 2), certiorari denied, 311 U.S. 674; *Jockey Club* v. *Helvering*, 76 F. 2d 597, 598 (C.A. 2). Moreover, it is relevant that petitioner's member-shareholders have attempted to devise some means for distributing its substantial surplus ($735,233.67 as of March 31, 1963) to themselves (R. 610).

As both courts below correctly held, exemption from taxation does not depend upon whether petitioner's outside income was derived from engaging in business. The existence of a profit-making purpose (which may be inferred from what the organization actually does) is the proper test. Assuredly, a club which carries on an active trade or business is not exempt. This does not imply, however, that a club with substantial and recurring outside profits *not* from a business is exempt. Accordingly, the Commissioner has long ruled that the receipt of outside profits *not* from a business may disqualify a club from exemption. G.C.M. 13067, XIII–2 Cum. Bull. 148 (1934); I.T. 2622, XI–1 Cum. Bull. 65 (1932). And the courts have so held. *Jockey Club* v. *Helvering, supra; Spokane Motorcycle Club* v. *United States,* 222 F. Supp. 151 (E.D. Wash.); *Spokane Commercial Travelers* v. *Squire,* 126 F. Supp. 424 (W.D. Wash.). Furthermore, the theory that an exempt club can maintain its exemption despite the receipt of passive income in an unlimited amount was rejected by the Fifth Circuit in *United States* v. *Fort Worth Club, supra.*

2. Petitioner contends that the decision below and the *Forth Worth* decision conflict with two earlier decisions of the Fifth Circuit in *Koon Kreek Klub* v. *Thomas,* 108 F. 2d 616, and *Scofield* v. *Corpus Christi Golf & Country Club,* 127 F. 2d 452. But such an intra-circuit conflict does not require resolution by this Court; if there is such a conflict, it is appropriately to be resolved by *en banc* consideration of the court of appeals. Taxpayer sought such an *en banc* considera-

tion in the *Fort Worth* case on precisely that basis (348 F. 2d 891); in denying such rehearing, the Fifth Circuit apparently treated its later decision as modifying the earlier ones, to the extent there might have been some inconsistency. Indeed, in *Fort Worth* the Fifth Circuit indicated that other authorities were "[c]loser in point, and more consistent with the legislative history of the statute" (345 F. 2d, p. 57). See also *Jockey Club* v. *Helvering, supra.*

3. Similarly, petitioner incorrectly argues that Congressional consideration of H.R. 15942, 89th Cong., 2d Sess., is relevant to the instant case (Pet. 10–12). That bill, as its title discloses, relates to the imposition of "a tax on unrelated debt-financed income of tax exempt organizations." It is designed to expand the "unrelated business income" provisions (§§ 511–512) of the 1954 Code in order to deal with the problem considered by this Court in *Commissioner* v. *Brown,* 380 U.S. 563. As observed by the court of appeals in its *Fort Worth Club* opinion (345 F. 2d, p. 56), the "unrelated business income" provisions never have applied to clubs, and the "only reasonable inference" to be drawn from their deliberate exclusion is that Congress assumed that clubs receiving such income would be barred from exempt status by the terms of § 501(c)(7). Viewed in that light, there is nothing in the terms or background of H.R. 15942 to indicate legislative dissatisfaction with the manner in which the courts have construed § 501(c)(7) in determining the tax status of clubs.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 1146

THE COASTAL CLUB, INC., *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

REPLY BRIEF FOR PETITIONER

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REPLY BRIEF FOR PETITIONER

Petitioner respectfully submits this reply to the Memorandum For The Respondent In Opposition, filed on April 13, 1967. The purpose of such reply is first to point out that petitioner and respondent appear to be in agreement as to the criterion used by the Tax Court and the United States Court of Appeals for the Fifth Circuit in revoking petitioner's exemption as a

social club under Section 501(c)(7) of the 1954 Code; secondly, to challenge the authorities cited by respondent in support of such criterion; and, finally, to answer respondent's contention that the decisions below do not present a conflict with other authoritative interpretations of such statutory exemption which should be resolved by the Supreme Court.

(1) At the top of page 4 of his Memorandum In Opposition, respondent makes plain his agreement with petitioner's contention that the Tax Court and the United States Court of Appeals for the Fifth Circuit below used as their criterion for revoking petitioner's exemption as a social club a new test, namely whether a "profit-making purpose" exists with respect to petitioner's passive receipt of outside income (but apparently only where such profits exceed some undefined amount described only as "substantial"), rather than the test which had theretofore been applied by the courts, to wit, whether a social club's outside income is derived from engaging in business.

At pages 2 and 3 of his Memorandum In Opposition respondent states that petitioner's outside income inured to the benefit of its member-shareholders by virtue of the fact that such income, while never actually distributed, was used to meet petitioner's expenditures for club purposes. Petitioner points out that where a social club has not engaged in business and its outside income has been used solely for club purposes, the traditional view of the courts has been that such use does not result in the inurement to the benefit of private shareholders proscribed by Congress. See *Santee Club* v. *White*, 87 F. 2d 5 (1st Cir. 1936); *Koon Kreek Klub* v. *Thomas*, 108 F. 2d 616 (5th Cir. 1939); *Anderson Country Club, Inc.* v. *Commissioner*, 2 T.C. 1238

(1943); *Coeur D'Alene Country Club* v. *Viley,* 64 F. Supp. 540 (N.D. Idaho 1946); and *Clements Buckaroos* v. *Commissioner,* T.C. Memo 1962-18 (1962). It is only in those cases where the outside income is first determined by the court to be derived from the conduct of a business that the use of such income solely for club purposes has been held to inure to the benefit of private shareholders. See *Aviation Club of Utah* v. *Commissioner,* 162 F. 2d 984 (10th Cir. 1947) *which respondent significantly fails to cite; West Side Tennis Club* v. *Commissioner,* 111 F. 2d 6 (2nd Cir. 1940); and *Jockey Club* v. *Helvering,* 76 F. 2d 597 (2nd Cir. 1935).

It is submitted that the authorities cited by respondent at page 4 of his Memorandum In Opposition do not support his position that the existence of a profit-making purpose is the proper test for judging whether a social club's outside income is contaminated. G.C.M. 13067, XIII-2 C.B. 148 (1934), cited by respondent, involved the income-producing activities of an association of clubs. Such activities consisted of "sponsoring, conducting, or managing tournaments, handicapping players, and attending to matters incident to the tournaments", all of which adds up to conducting a business with the general public. See *West Side Tennis Club* v. *Commissioner, supra.* Respondent also relies on I.T. 2622, XI-1 C.B. 65 (1932), holding that a single sale of real property no longer useable for exempt purposes cost the social club its exemption, but this clearly conflicts with the 1937 amendment of the Regulations on social clubs recognizing for the first time, pursuant to *Santee Club* v. *White, supra,* that "an incidental sale of property will not deprive the club of exemption".

Respondent also cited *Jockey Club* v. *Helvering, supra,* in support of his proposition, but there can be no serious doubt that the income-producing activities of the Jockey Club, including the maintenance of a horse-breeding bureau and breeding station, the registration of thoroughbred horses and the publication of a stud book, the supervision of horse races, the issuance of licenses to trainers and jockeys, the maintenance of a disability fund for disabled trainers and jockeys, and the publication of a monthly racing magazine, all added up, as the Fifth Circuit noted in *Scofield* v. *Corpus Christie Golf & Country Club*, 127 F. 2d 452, at page 454, to "the *business* of public amusement or entertainment, from which it derived from the *public generally,* and not merely from its members, *large revenues.*" (Emphasis supplied.)

Respondent also looks to *Spokane Motorcycle Club* v. *United States,* 222 F. Supp. 151 (E.D. Wash. 1963) for support, but it is significant that in such case the District Court found at page 152 that most of the gross income was "from sales of tickets, goods and services for hill climbing events and paid by the general public", and at page 153 of its Opinion the Court referred to these sales as a *"business enterprise".* Respondent points to *Spokane Commercial Travelers* v. *Squire,* 126 F. Supp. 424 (W.D. Wash. 1954), but the revocation of the club's exemption is easily explained by the fact that the club maintained a fund for the payment of death benefits to beneficiaries named by its members, so it clearly violated the proscription of the exemption statute against inurement of earnings to the benefit of members.

Respondent is mistaken in looking to *United States* v. *Fort Worth Club of Fort Worth, Texas,* 345 F. 2d 52 (5th Cir. 1965) for rejection of the theory that an

exempt club can maintain its exemption despite the receipt of substantial amounts of passive income. In its subsequent decision on a petition for rehearing in that case, the Court of Appeals succinctly summarized at 348 F. 2d 891, 892, the crux of its prior holding: "We *held only* that the Fort Worth Club, because of substantial and recurrent outside *business* income, is not entitled to exemption from income tax as a social club * * *." (Emphasis supplied.) It is significant in this connection that respondent leaves unchallenged petitioner's contention that the criterion thus adopted by the courts below in the instant case conflicts with *Anderson Country Club, Inc.* v. *Commissioner, supra,* acquiesced in by respondent, 1944 C.B. 2, and the decisions of the United States Court of Appeals for the Fifth Circuit in *Koon Kreek Klub* v. *Thomas, supra,* and *Scofield* v. *Corpus Christi Golf & Country Club, supra.* All three cases involved the receipt of substantial amounts of outside income, and the first and third of these cases involved recurring and continuing income over a considerable period of time.

Thus, it would appear clear that there is no prior authority for the criterion used to revoke petitioner's exemption, and that the instant case is the first one in which a court has held that a social club not engaged in business loses its exemption merely because it realizes too much income from the disposition of its surplus property, consisting of mineral rights which were acquired merely as an incident to the ownership of land and which were of no use to the club.

(2) In the second part of his Memorandum In Opposition, respondent attempts to rebut petitioner's contention that the decision of the Fifth Circuit below conflicts both with its earlier decisions and with re-

spondent's interpretation of existing law in his sponsorship of H.R. 15942 and H.R. 15943 in the Second Session of the 89th Congress. The United States Court of Appeals for the Fifth Circuit took particular pains in its Opinion in the *Fort Worth Club* case, *supra*, at page 57, to distinguish the *Koon Kreek* case on the ground that such club "did not engage in those activities as a business", and to distinguish the *Corpus Christi* decision on the ground that "the royalties the club received were 'merely an incident to the ownership of the land', and that the club was neither 'actively engaged in operating non-club activities', nor did it derive income 'from the public generally' ". In the light of such concerted efforts by the Court of Appeals to distinguish the *Koon Kreek* and *Corpus Christi* cases from the commercial lease operations of the *Fort Worth Club* then before it, it would have been surprising indeed if, in subsequently denying a petition for rehearing in the *Fort Worth* case, the Fifth Circuit intended, as respondent now suggests, to treat its decision as modifying the earlier ones, and petitioner can find nothing in the text of the Opinion on the petition for rehearing, 348 F. 2d 891, 892-893, to indicate that such was the case.

Respondent also contends that Congressional consideration of H.R. 15942 and H.R. 15943, and the Treasury's sponsorship of such bills through the Assistant Secretary of the Treasury, are irrelevant to the instant case because such bills relate to the imposition of "a tax on unrelated debt-financed income of tax exempt organizations" designed to expand the "unrelated business income" provisions which "never have applied to clubs". This argument completely misses the point that the proposed bills *would tax social clubs,*

as well as all other exempt organizations, on their "unrelated debt financed income" but *would leave unaffected "income produced by investments of an organization's own funds"*. This is clearly indicated, not only by the bills, but also by Assistant Secretary Surrey's testimony which discloses that the Treasury Department's sponsorship of the bills was based upon a broad and comprehensive survey and analysis of existing law.

CONCLUSION

The conflicting views set forth in the briefs filed in the instant proceeding only serve to emphasize the urgent need for the Supreme Court to answer the troublesome questions, on which the exemption statute is silent, as to the nature and amount of outside income a social club may receive without the extremely harsh and irrevocable loss of its exemption.

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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